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COOPERATION *with the* S. E. C.

THE S. E. C. *and* THE ACCOUNTANT

THE PRESENT-DAY SCOPE *of* MONTHLY AUDITS

SPECIAL FEATURES *of* MONTHLY AUDITS

MONTHLY AUDIT ADMINISTRATION, WORKING PAPERS *and* REPORTS

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THE NEW YORK STATE SOCIETY OF CERTIFIED PUBLIC ACCOUNTANTS

Objects of the Society

"To cultivate, promote and disseminate knowledge and information concerning accountancy and subjects related thereto; to establish and maintain high standards of integrity, honor and character among certified public accountants; to furnish information regarding accountancy and the practice and methods thereof to its members, and to other persons interested therein, and to the general public; to protect the interests of its members and of the general public with respect to the practice of accountancy; to promote reforms in the law; to provide lectures, and to cause the publication of articles, relating to accountancy and the practice and methods thereof; to correspond and hold relations with other organizations of accountants, both within and without the United States of America; to establish and maintain a library, and reading rooms, meeting rooms and social rooms for the use of its members; to promote social intercourse among its own members and between its own members and the members of other organizations of accountants and other persons interested in accountancy or related subjects; and to do any and all things which shall be lawful and appropriate in furtherance of any of the purposes hereinbefore expressed."

—*From the Certificate of Incorporation.*

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THE NEW YORK STATE SOCIETY OF
CERTIFIED PUBLIC ACCOUNTANTS

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to reduce to a minimum the expense and practical difficulties imposed by law and regulation on the conduct of the securities business.

In drawing upon the Commission's work for specific illustrations of the type of problem which needs your cooperation for its happiest solution —if we are to avoid the imposition of further strict governmental regulation—I can think of no field more fertile, nor more appropriate to this gathering, than the field of accounting practices. As you all know, the heart of the Commission's work under the Securities Act lies in securing full and honest disclosure of the basic information without which no purchaser of securities can be expected to decide intelligently whether a security is worth investing in; and accounting, being the science of organizing and presenting financial information in complete and accurate form, is the handmaiden of the principle of disclosure. The aims of the accountant and of the Commission lie very close together.

And yet we find that the vast majority of stop order proceedings instituted by the Commission to prevent the further sale of securities on the ground that the basic data have been falsely or fraudulently represented, arise out of the failure of accountants accurately to disclose the history and present state of their clients' affairs. Many of such cases, it is true, may involve plain and wilful fraud, and such cases need not concern us here, for we are not engaged in discussion of what to do about the crook. Many another case, however, as well as many a case evoking merely criticism and condemnation from the Commission without the institution of stop order proceedings, arises out of the adoption of accounting practises which, though inherently deceptive, are nevertheless recognized by state corporation laws and therefore accepted and followed by accountants without incurring censure from their organized professional associations.

In order that I may not be accused of mere generalized criticism, let me take a few examples of accounting practices which are deceptive in their nature, and which nevertheless recur continually in registration statements filed with our Commission.

One outstanding example of the type of practice frequently condemned by the Commission is the practice of concealing promoters' profits in over-valued property accounts. You are all familiar with the problem: promoters, having acquired property of dubious or merely prospective value, transfer the same to a corporation which they have organized, in return for all or a portion of the corporation's stock. The property is then set up on the corporation's books either at the par value of the stock issued to the promoters, or at some arbitrarily selected stated value. In either event the figure at which the asset is set up on the balance sheet is frequently grossly excessive.

It would be difficult to conceive a practice more readily lending itself to deception. Yet accountants have by no means set a uniform face against the practice; nor is any effective deterrent afforded by the common law or by state statutes. The frequent lack of a realistic approach by the courts to the problem of promoters' responsibility to the corporation and its other stockholders; the many technical pitfalls besetting actions even by creditors; the further encouragement to dishonest promoters that was offered by the introduction of the device of no-par stock; the difficulty of proving the necessary elements in an action of fraud and deceit — all these have many times been observed. The decisions of federal courts in particular have not been such as to discourage this type of over-valuation. In *Old Dominion Copper Co.* v. *Lewisohn* the Supreme Court held thirty years ago

that, so long as all the stockholders at the time of the sale of the property to the corporation were aware of the facts and had ratified the transaction, the corporation was bound by its consent thus given, and no action might thereafter be maintained by it against the promoters, even though other investors subsequently purchased authorized but unissued stock from the corporation without knowledge of those facts. Since the promoters usually comprised all the stockholders at the time of the sale to the corporation, this rule, of course, effectively immunized them from any liability. *McCandless* v. *Furlaud,* decided two years ago by the Supreme Court, may have made some inroad into this doctrine, but it is questionable whether it overthrew it. A bare majority of the state courts, it is true—New York does not seem to be among them—follow what has come to be known as the Massachusetts rule, enunciated in *Old Dominion Copper Company* v. *Bigelow.* Under this rule the promoters' fiduciary duty is considered to extend to incoming subscribers in cases where the promoters held all of the issued but not all of the authorized stock at the time of the corporation's consent and where as part of the original plan of promotion the corporation later issued additional stock to persons unaware of the promoters' profit. Even these courts, however, concur in the federal rule to the extent of holding that the corporation may not recover when, at the time of the corporation's consent, all of its authorized stock was outstanding and held by the promoters, even though the promoters themselves immediately resold the stock to the public as part of the promotion scheme. Even under this relatively enlightened doctrine, then, the promoters need be careful only to take all the authorized stock, and so far as the laws of liability are concerned, they will have virtual *carte blanche* to set up the properties at grossly excessive valuations, and by means of this misrepresentation of asset value induce into their enterprise a credulous public. And where the laws of liability do not prohibit or deter, too many an accountant has been willing to accede to the demands of an unscrupulous and self-seeking client.

The example I have given is obvious to all. Less crude, though perhaps no less obviously filled with the seeds of deception, is the scheme whereby preferred stock is sold to the public under such circumstances that a large part of the proceeds is made legally available to common stockholders by way of dividends. The operation is simple: preferred stock is issued with a par or stated value of $5 per share, a liquidation value of $25 per share and a redemption price of the same. Relying upon the liquidation and redemption values, the public is induced to purchase at an offering price of $25 per share. The corporation, however, sets the stock up in its capital account at $5, the par or stated value, the $20 balance being credited to a surplus account available for common stock dividends. At the best the preferred stockholder is mislead as to the true degree of protection to which his investment is legally entitled; at the worst, he may wake up one day and find that four-fifths of his investment has been expropriated and that he is without remedy.

I doubt if any of you would argue in support of deception of this character. Preferred stock sold as I have suggested is in every real sense offered as a twenty-five rather than a five dollar investment, and it is nothing more or less than fraud to take advantage of a nominal "par" or "stated" value to permit diversion of the proceeds of sale into the pockets of junior security holders. Yet the Delaware corporation laws seem rather clearly to sanction such a practice, and the New York corporation laws at least do not clearly prohibit it. It may well be that, notwith-

standing statutory permission, a court of equity would be persuaded, at the suit of a preferred stockholder, to enjoin such a patent misappropriation of his investment; but this question is still unsettled, and again, where the law does not prohibit, the accountant has been willing to go.

I will not weary you with a further detailed statement of examples. Suffice it to refer briefly to the recent widespread practice of reducing depreciation charges by means of arbitrarily writing down fixed assets, for the purpose of freeing current income for the payment of dividends; the failure of many companies to restrict their earned surplus accounts for the cost of their own stock reacquired and held in the treasury; the failure of many companies to employ any scientific method of determining depreciaton for the purpose of the accounts which they present to the potential investor, even though the same companies may be very careful to work out an orthodox straight-line depreciation scheme for tax purposes. Those of you who are acute to the professional responsibilities of the accountant can fill in the outlines and could yourselves produce many more examples of equally questionable character.

We in the Securities and Exchange Commission are not entirely remediless in coping with these abuses. From the Unity Gold Corporation case, decided by the Federal Trade Commission at the outset of its administration of the Securities Act, through the Queensboro Gold Mines case, decided only a few weeks ago, the Commission has not hesitated to attack with its heaviest artillery—the stop-order proceeding—registration statements containing misrepresentations of the value of assets acquired from promoters. In cases not meriting this severe penalty, we have at least secured a modicum of disclosure by requiring that any purported independent valuation or appraisal be supported by a statement of its basis, and that valuations not purporting to be thus based be footnoted to indicate not only the relationship of the vendor to the corporation, but also the purely arbitrary character of the valuation. Where the valuation is at par and contemporaneously stock has been sold to the public below par, even this explanation has not been permitted to suffice, for misrepresentation cannot be cured merely by apology. Similarly, where preferred stock has been capitalized at below its liquidating and redemption values we have done our best to minimize the deceptive character of the operation by requiring a footnote to the balance sheet indicating the aggregate liquidating value and also stating the opinion of registrant's counsel as to the legality, from the point of view both of statute and of possible equitable remedies, of any use of the so-called surplus for common stock dividends. Lawyers dislike giving such opinions, but the need is one of their own, or their clients', making.

Yet these sanctions, though they may serve as piece-meal protection to the public in the individual instances which come before our Commission, are not sufficient from the point of view of any long-range program. True, we may demand and even compel full disclosure of the inherently dishonest or deceptive character of particular devices; but misleading practices accompanied by confession of dishonesty are but poor substitutes for straightforward and conscientious accounting principles. Elimination of unsound accounting, not merely disclosure of its unsoundness, is the goal.

Here, then, I return to my central theme, the essentially cooperative nature of the job of government and business. We may bring stop-order proceedings. We may serve notice of deficiencies and use our salutary power to delay, at least for a period, the public offering of securities until the deficiencies are corrected. We

may circulate, as we have done, the opinions of our Chief Accountant, Carman G. Blough, as to the fundamental principles underlying the accountant's function as an aid to disclosure. But these are not enough, for they are either fragmentary or purely advisory. What we, or you, or both of us, must do, is to get a clear picture of the scope of the problem, and then attack it concertedly.

There are two remedies. One lies with us. We may, as we have not yet done, seek to develop our rule-making power under the Securities Act for the formulation of accounting rules designed to impose minimum standards of accounting theory and practice upon accountants whose work is to be submitted to our scrutiny. Already, as Judge Healy announced in his recent address before the annual meeting of the American Accounting Association, efforts along this line are being undertaken by the Commission's staff, with a view to codifying a few of the more elementary standards of sound accounting which are accepted by a majority of good accountants. As we now visualize it, this program is no more than a cooperative attempt on our part to aid the accounting profession in its own efforts to fix and maintain the standards to which all responsible and independent accountants already adhere. We should deplore as much as you the necessity of going further, and imposing drastic government restriction and supervision on the practices of accountants.

The alternative to a more pervasive policy of government regulation of accounting practices lies with you. By this I do not mean that you have not, both individually and through your professional associations, contributed heroically to the task of raising accounting ethics. Much has already been done. But even the best intentioned and most conscientious accountant may hesitate to refuse, merely in the interest of sound accounting theory, to comply with the wishes of his client in following practices clearly sanctioned by state laws; and much therefore remains to be done in the way of overhauling state laws which authorize or permit practices repugnant, as many of those I have described must be, to the ideals of the profession. Therefore, it is incumbent upon you, if you would do your part of the job, not only to establish your own standards of sound practice and theory, from which you will not be swayed by the importunities of your clients, but also to lend the full weight of your influence to revision of those corporation laws which serve as temptations to depart from that objectivity essential to a proper discharge of the accountant's duties. Laws themselves, you must recall, are the product of public demand for the codification of standards evolved by the public conscience; and the articulate members of interested professions are the most potent force in the crystallization and codification of those standards.

Thus far I have been talking primarily to the accountants, and although I have done my best to stress the cooperative nature of the job which faces both us and them, I fear some of you may feel that I too have taken the position that cooperation means that the other fellow should do something about it. To protect myself against this charge, let me discuss briefly before I close an entirely different field where joint efforts by government and business are needed to bring about results desired by both—a field in which the demand for improvement has come from business rather than government, and in which government, rather than business, is on the defensive. I refer to the problems created by the overlapping of federal and state jurisdictions over the issuance and sale of securities.

Outstanding among the problems facing the investment banker, the lawyer and the accountant alike, in

preparing for the distribution of a new issue of securities to the public is the problem of meeting the diverse requirements of state and federal regulating bodies. We in Washington realize no less than you—perhaps because you so frequently tell us about it— the sheer physical burden of work involved in registering or qualifying an issue of securities under the laws not only of the Federal Government but also of the several states in which the offering is to be made. What you gentlemen often fail to realize, I believe, is that by and large we in the government are no less anxious than you to achieve simplicity and uniformity, to reduce the burden of detail and red tape, and to concentrate our efforts and yours in a joint endeavor to reach the simple objectives of the Securities Act—full and honest disclosure of the basic facts which must be known before anyone can intelligently make up his mind whether or not a security is worth investing in.

If this be so, you may ask, why do not we in the government take more affirmative steps towards the simplification and integration of the processes of governmental supervision of the issuance of securities?

To answer this question let us review briefly the history of the problem. As you know, entirely apart from the Securities Act of the Federal Government, and long before any statute of so sweeping a character had been even conceived, the several states of the Union were engaged in the enacting of "blue sky" laws of one kind or another. Over a period of a generation such laws have been enacted in 47 out of the 48 states. These statutes have varied widely in character, but in general they fall into three classes: the so-called "fraud statute", of which your own Martin Act is a modified form, the "disclosure" statute upon which the Securities Act is based, and finally the type of statute which requires qualification and even approval of the merits of securities before they may be offered to the public.

While these statutes undoubtedly did much for the ten millions or more of investors in the country, their effects were, of course, necessarily limited by the constitutional restraints of our federal form of government. Full realization that the distribution of securities had become in large measure a nation-wide business with which the individual states could not successfully cope came only after the depression of 1929, and, when it came, led to the enactment of the Securities Act. This federal statute, however, sought to do no more than impose basic standards of honesty and completeness in the disclosure of the facts from which alone understanding of the merits of securities can be gained. The Securities Act could not, and did not seek to supersede state control of the sale of securities within their own boundaries; it could, and did, implement state laws by providing basic standards of disclosure for all issues not purely local in character.

With the theory of state supervision and federal coordination few of you would disagree. Yet you and we both know that much still remains to be done to adjust this theory to the practical exigencies of modern interstate financing. Lawyers and accountants alike may be glad to lay before both the Securities and Exchange Commission and the commissions of the several states where their clients' securities are to be sold, all of the facts bearing upon the nature and merits of the securities. But they resent, with a well justified bitterness, the demand that the same information be submitted to half a dozen or more commissions in an equal number of different forms and on an equal number of different time schedules. It is not the fact that so many governmental bodies are inquisitive about us, they say, but that each one of them has its own

idea of how they want us to explain our proposition.

Here, then, is the second example I would give you of the need for cooperation between government and business. Failure of state and governmental authorities adequately to integrate their regulatory processes is of concern to government and business alike; for the irritation of business in its efforts to satisfy government can only result in creating friction which decreases the efficiency of government. The job of bringing about a closer integration between these processes is a joint one for business and government.

Some recognition of the problem, and attempt at its solution, is already being manifested by government. In Massachusetts a commission was created at the last session of the general court for the purpose, among other things "of making a survey and study of the laws of the commonwealth regulating or otherwise pertaining to the promotion and sale of securities, with a view to bringing said laws into harmony with the Federal Security Act of 1933". In Pennsylvania and Michigan consideration was given at the last sessions of their respective legislatures to laws designed to effect a similar integration; and in Maryland the problem has received some consideration from State officials. The National Association of Securities Commissioners resolved at its 1936 conference that the Association "accept such forms that might be drawn and presented by the committees on uniform registration statements, as far as they are applicable to the laws of the several states". And in South Carolina a law was adopted in 1936 under which "seasoned" securities registered with the Securities and Exchange Commission on Form A-2 may be qualified in South Carolina by a simple process of "notification".

These developments in the process of integration have, I believe, had the hearty support and assistance of such organizations as the Investment Bankers Association and the Investment Bankers Conference, Inc. These and other similar organizations have recognized that the impetus must come from business as well as government—that even the best intentioned government officials may frequently be so busy in the handling of day to day details of administration that the development of long-range programs may lag sadly unless stimulated by the constructive criticism and suggestion of interested and informed professional groups. If you and your representative associations will believe, and act on the belief, that this constructive criticism and suggestion not only is welcomed by government but also helps government to do its part in the attaining of objectives desired by both, the attaining of those objectives will be vastly easier.

The S. E. C. and The Accountant

By Victor H. Stempf, C. P. A.

MR. LANE should be thanked, and through him the Securities and Exchange Commission, for the constructive tenor of his address in respect of cooperation between the S.E.C., Business, and the Professions. To this we all shall gladly pledge our aid. Likewise do we welcome the recommendation that a concerted effort be made to bring about uniformity in State requirements thereby solving the aggravating problem of meeting the diverse demands of State and Federal Regulatory Bodies. Concerning the overhauling of State laws "which authorize or permit practices repugnant to the ideals of the profession", we say: "amen". Mr. Lane wisely says:

> "Laws are the product of public demand for the codification of standards evolved by the public conscience; and the articulate members of interested professions are the most potent force in the crystallization and codification of these standards."

We know of cooperation between C. P. A. Societies and Bar Associations in revising corporate statutes which has borne fruit in the more progressive states. The proposal is thoroughly practicable, and the Board of the New York State Society of Certified Public Accountants should be urged to participate in such projects in collaboration with the Bar and others.

Extremes as Criteria

In depicting transgressions which require reform, all are prone to seize upon extremes which emphasize the issue. Mr. Lane will, no doubt, agree with this statement. Laymen, unfortunately, and the Press, almost invariably interpret these extremes as typical of general practice. Certainly, this was not Mr. Lane's intent, nor that of his associates on other occasions, in drawing upon "Stop Order" cases to exemplify the points discussed. Someone has spoken, recently, of the "tyranny of words". The phrase is apt on this occasion. Although Mr. Lane has said: "the aims of the accountant and of the Commission lie very close together", he has also said: "Yet accountants have by no means set a uniform face against the practice." Moreover, he has said: "And where the laws of liability do not prohibit or deter, too many accountants have been willing to accede to the demands of unscrupulous and selfseeking clients." Rightly or wrongly, the impression prevails that these utterances intend a general accusation. This, we may be sure, was unintentional. Certainly, we must demur to any such implication. We should remind ourselves and others that the organized profession has aggressively championed sound accounting principles and the fair disclosure of material facts for many years. By no means marking the beginning of the crusade, but as tangible evidence, one needs only recall the pamphlet entitled: "Approved Methods for the Preparation of Balance Sheet Statements", issued by the profession in April, 1917 under the auspices of the Federal Reserve Board, the revised edition of the pamphlet in 1929, and the current revision prepared and published by the American Institute of Accountants in January, 1936 entitled: "Examination of Financial Statements." These documents conclusively establish the fact

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These comments reconstruct substantially the extemporaneous statements made at the January 11, 1938 meeting of the Buffalo Chapter of The New York State Society of Certified Public Accountants.

that the profession has earnestly fostered sound principles and practice in financial reporting.

Throughout this period, the profession has recognized that the divergent standards of the law concerning Capital Stock, Surplus, Dividends, and Treasury Shares, for example, have supplied an unsatisfactory basis for financial reporting insofar as the disclosure of material fact and criteria of sound accounting practice are concerned. The struggle has been long and arduous, sometimes discouraging. The gains have not been made by the spectacular "forward pass" but by "bucking the line" persistently in a slow but steady advance toward the goal. In any well ordered society effective reforms are the product of evolution, not revolution. If you will review the transition in accounting practices in this country during the past fifty years you will be astonished by the acceleration in that progress; but even to those of us who have shared in the latter half of that period the advance has seemed very gradual. Speed is always relative; and sound, lasting change may be accomplished best by deliberate action, as opposed to hastily conceived radical changes.

Overvaluation of Properties

The abuses which are latent in promotional overvaluation of properties are self-evident. The profession has been aware and wary of these situations, and the difficulties besetting the accountant's task have not been lessened by the Court precedents which fail to deter overvaluation. It may be said that the profession has definitely "set its face against such deception" for many years. It should be emphasized, however, that it is not the flagrant cases which create a problem, but the many borderline transactions. These do indeed tax the accountant's ability. It is one thing to recognize deceit in capitalizing a woodshed as if it were a mansion, and quite another matter to pass judgment upon the propriety of values attributed to properties of obvious merit and appropriate utility. There are many such cases in which the accountant may with propriety rely upon expert opinion. The accountant is not an appraiser of quality or value, notwithstanding that, within the limitations of exceptional experience and training, he may be qualified to hold an opinion. He has the right to rely upon the judgment and opinion of qualified experts, or the judgment of management:

> "He does not undertake in practice to substitute his judgment for that of management, when the difference is not of major importance, when the management's judgment is not unreasonable, and when he has no reason to question its good faith."

Paid-in Surplus

The profession has long insisted that the Law provides at best an unsatisfactory basis for candid portrayal of financial facts, in respect of the creation of Paid-In Surplus by the issuance of stocks at prices in excess of their par or stated values, and the related questions of dividends distributed out of such surplus. The consensus in the profession has urged the clear segregation of such paid-in surplus, and has opposed the payment of dividends from such surplus as being in fact a distribution of capital (paid-in capital), although not technically out of the "trust fund" represented by the amounts assigned to issued shares. The position of the profession in this respect has not been without opposition from business and certain members of the Bar, who have insisted upon the contrary, economically unsound, legal concept.

Depreciation

The question of depreciation is admittedly one of the most perplexing problems of business and financial reporting. Many accountants in the

present group have heard the argument advanced by otherwise reasonable business men that physical deterioration of equipment is more than offset by appreciation of land. They have also heard other similar arguments, all of which are greeted with derision today. Twenty-five years ago most businesses provided depreciation sporadically, if at all; and usually only to the extent that profits could bear the charge. Consistency of method and the useful life of assets were disregarded. The establishment of sounder bases of fixed asset accounting was a crusader's job, the brunt of the battle being borne by accountants. The Bureau of Internal Revenue has not helped to solve the problem on an economically sound basis. In all fairness, no one can deny that the Bureau has resisted allowances exceeding an irreducible minimum; whereas the opinion is widely held that provisions for depreciation, generally speaking, have been far too low for many years.

Technological improvements in productive equipment have come much faster than it has been possible to assimilate them. A substantial portion of investment must be recovered before business can afford to scrap the old and adopt the new. Managements with real vision realize this, and accelerate amortization as far beyond the ordinary bounds of useful life as may be possible in the light of competitive prices, financial policy, and tax deterrents. On the other hand, too many business men permit tax aspects to discolor their reasoning and to distort the application of conservative accounting practices. Definite liberalization of depreciation allowances should be encouraged within reasonable limits of consistent practice and sound accounting and engineering bases. The crux of the matter lies in the fact that the analyses of fixed assets available in the average business are far too meager. The problem cannot be attacked intelligently without fully detailed unit control records of such assets. Paradoxically, T.D. 4422, and the Commissioner's mimeograph 4170 did much to stimulate further analysis of fixed assets, although these regulations were quite obviously designed to further the objectives of the Ways and Means Committee in reducing depreciation deductions theretofore allowed.

In too many cases the analysis of fixed assets has not been carried far enough: insufficient sub-classification, too many composite rates, not enough unit control. Only in exceptional cases has this job been done fully and well. Until this work is more broadly undertaken, depreciation will continue to be a sore spot in accounting practice. For the purpose of interpreting the history of equipment as an aid to forecasting life expectancy; for the control of maintenance and replacements; for the purpose of checking the adequacy of depreciation provisions by means of "observed depreciation"; in fact for the control of the existence and possession of assets purporting to belong to the business, unit control records are essential. Beyond all of these aspects of depreciation is the more important question of the soundness of the original basis of stating the amount of fixed assets. For example, the sanction of conventional practice for many years permitted the use of "Cost" as a designation for assets acquired partly for cash, partly for stock, or as a part of a mixed aggregate of assets for an upset consideration of cash, or stock, or both. The stock issued by the purchaser may have borne a par value or may have been of no par value. If the latter, it may have had an assigned value at the time of issuance, or a minimum stated value. The value attributed to the fixed assets may have been based upon appraisal of the assets at the time of acquisition, but it is far more likely that the amount adopted may have

been arbitrarily based upon the par value, minimum stated value, assigned value, perhaps upon book or even market value at the time of issuance of such stock. The cost or other basis of fixed assets to a vendor probably has no relation to the utility of such assets to a purchaser. Appraisal at time of acquisition is obviously indicated if one would approach the question accurately. Here again, we should note, questions of taxation have beclouded the issue and reared barriers to an economically sound solution of the problem. The tax base of depreciation of property in the hands of tranferor and transferee, complicated by questions of tax-free reorganizations, and related problems have added difficulties which are most perplexing.

With all of these problems the accountant has struggled valiantly to the best of his ability. It is quite simple to rear ideals of perfection. It is quite another matter to deal practically with the day-to-day problems of business. We may be proud of the progress that has been made, and at the same time admit that much remains to be done. Certainly, as to the need and importance of adequate disclosure in respect of these matters, we may give our unqualified endorsement.

Flexible Rules and Standards

The fact that inadvertent, or even intentional, abuses of the application of accounting principles may have been apparent in exceptional cases, should not preclude the application of such principles in cases where they are soundly and consistently applied. The establishment of inflexible rules and standards will never prevent abuses. Honesty of purpose is essential. The accomplishment of the profession, and its high standing in the business community bear undeniable testimony of integrity. This ideal we shall continue to guard jealously. Likewise, the profession may be counted upon to lend every cooperation in the solution of these joint problems of business, the investor, government, and the profession. We deplore the suggestion that accounting principles should be put into a straight-jacket. We should be eager to find new and correct uses of principles, if we are to keep pace with the development of commerce.

Principles are not inventions, but rather discoveries of basic truths; and although basic principles are fixed, their application to unlike situations is varied. Uniform accounting practice has a place in industry when comparable conditions prevail, but its application is limited. Differences in accounting methods between separate establishments in an industry are often branded as random differences, when the truth is that they are carefully considered distinctions, based on a clear grasp of essential conditions and designed to present the material facts of each business in such form and sequence as management deems best suited to the purpose. Consistency of application is the prime essential, and freedom of choice of the methods best suited to a given case should remain unconfined. Popular allegations of "lack of accounting principles" arise out of a failure to discriminate between principles as such and the varied application of the principles, which is essential in respect of the unlike characteristics of different businesses. We should resist strongly the prescription of rigid rules, and stoutly defend the necessity for flexibility in the application of accounting principles.

In passing, attention should be directed to the admirable work which has just been published by the American Institute of Accountants, entitled: "A Statement of Accounting Principles", prepared by an independent Research Committee, headed by Dr. Sanders of Harvard. The standing of the authors of the report marks the volume, as a most valuable contribution to the subject destined to become a highly important

historical document in the annals of accounting. The Sanders' report deals not alone with those things which may be called fundamental principles as such, but also with related subordinate rules of accounting, and stresses that:

> "An understanding of the extent to which judgment has thus entered into the preparation of accounting statements is essential to the comprehension of them."

The report seeks to clarify the distinction between principles and their application by the following statement:

> "The existence of a body of generally accepted accounting principles does not mean that there is only one proper accounting treatment for every situation with which the accountant must deal. For many such situations there are available a number of treatments which are in accord with the generally accepted principles. But the affirmation of the general acceptance of accounting principles does mean that many and, indeed, most of the possible treatments are inappropriate. The failure to see that it is not the essential nature of a principle to forbid all courses of action save one, that a rule of conduct which permits some course of action and forbids others is a principle, explains, it is believed, the denial by some of the existence of accounting principles and their general acceptance."

It is to be hoped that the Sanders' Report will stimulate continued discussion for it is, of course, inconceivable that the Report, admirable though it is, will be accepted in toto by the profession. Out of such discussion should grow a body of principles accepted by the profession as a whole. It must be recognized, however, that to the extent that such statements relate to the application of principles we shall continue to have transition in accounting practices to fit the changing needs of Commerce.

In Conclusion

The Securities and Exchange Commission will have a part in moulding the accepted applications of accounting principles. The profession should welcome mutual cooperation in this regard. It should be borne in mind that the Commission's viewpoint is necessarily influenced by its interpretation of the Acts which it is called upon to administer. In seeking to serve that purpose, the demand for detail relating to current years, and historical information concerning earlier years should not be made unduly burdensome. The objective should be simplicity and brevity without jeopardizing the adequate disclosure of material fact. Much that the Commission has done, in challenging alleged deficiencies in registration statements, has sought to protect the issuer, underwriters, and experts from the liabilities of the Securities and Exchange Acts; and its rulings are rapidly building a reassuring body of precedent concerning the things that are needed to properly disclose material fact; but there is grave danger that an increased demand for information will rear an intolerably unwieldy mass of data, the preparation of which will involve time and expense utterly incommensurate with the object to be served.

The Present-Day Scope of Monthly Audits

By Lawrence J. Seidman, C. P. A.

IT IS appropriate to initiate my paper with the seemingly paradoxical statement that "a monthly audit may not be a monthly audit".

It might be well, therefore, before proceeding further, to define the subject of review so that all of us may be speaking the same language. I shall, with the license of nomenclature accorded us, classify a monthly audit as—an examination of the books of account of any business concern on a continuous basis, the frequency of which ranges from once a week to once every three months, but usually once a month. Terminology that is often employed is "periodic audit" or "continuous audit".

The frequency of the audit will usually be dependent on one or more of the following factors:

First—The type of business in which the concern is engaged:

Most concerns find it expedient to use the calendar month as a fiscal time yardstick. Others, however, by necessity or custom, follow different procedure. A notable example is that of concerns engaged in the perishable foods industries. Among these an examination at weekly intervals is customary and arises by reason of the nature of the inventory in trade. In the theatrical business, (which includes night clubs, cabarets and very often, restaurants), the fiscal time unit is also a week, because those engaged in these enterprises have learned to measure business by weeks rather than by months. This time admeasurement offers, too, a more dependable barometer in these lines of endeavor and lends to closer comparison and analysis.

Second—The ability and adequacy of the concern's own staff:

The ability of the staff in compiling and presenting information to the management, as well as the element of internal control, is a consideration that both the management and the accountant must recognize in determining the frequency of examinations. An organization, properly knit from both business and accounting viewpoints, will require less frequent examination than one not well organized, all other things being equal.

Third—The size of the concern:

The size of the enterprise and the ability of its staff usually travel hand in hand. In the main, a large concern, one perhaps that might be termed as "big business", is well organized, has an adequate system of internal control, and accordingly may dispense with monthly audits. Of course, smaller enterprises may possess all the attributes in this direction of their larger brethren. As they usually do not, the need of more frequent audits is often present.

Last—Certain special situations:

The desirability of a monthly audit may arise from special circumstances surrounding the situation and need not originate from the foregoing factors. For illustration, businesses being conducted under absentee ownership arrangements or where special financial investments are involved, may undergo regular and frequent examinations. Let us dwell no further on the subject from the aspect of frequency.

Now then, generally, what are the purposes of a monthly audit? They

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can probably be expressed most clearly if divided into three broad classifications and considered from the respective viewpoints of the interested parties. Therefore, let us examine the facts:

Firstly—From the clients' viewpoint;

Secondly—From the credit grantor's viewpoint; and

Lastly—From the accountant's viewpoint.

In consideration of the first classification—the client's viewpoint:

There was mentioned earlier that for the most part "big business" did not avail itself of monthly audits by independent accountants. The probabilities are that the smaller client, and the client next in line as to size, are so manned that the regular periodic advice and assistance of an accountant, if not essential, are at least very desirable.

It is not unusual to find among the smaller business concerns an intermingling of the duties of the personnel. The bookkeeper may open the mail, check credits, prepare invoices and, perhaps, be required to perform a host of other duties. Oftentimes, there is more than one person in the office who will perform identical duties at the same or different times.

It is quite evident that in situations of this sort the element of internal control is practically absent. *Here is where the accountant fulfils a very important step —that, of supplying by his detailed monthly audit operations a form of internal control that the client is lacking under its own plan of operation.* Undoubtedly this is the greatest benefit that a small client derives from a monthly audit.

The detailed audit operations as usually set forth in the accountant's audit program, will insure by proper checks, a continuity of control in the examination of the client's affairs. If the audit program is properly prepared, it will automatically furnish a large portion of that internal control that would ordinarily be lacking; it will lead to a greater accuracy of the books and records from an accounting and bookkeeping standpoint; and it will minimize the possibility of pilferages, defalcations, etc. that the client might be subjected to. Although the accountant cannot *assure* the client as to the foregoing, he certainly can ease the management's mind in that direction.

There was pointed out previously that the accountant might render regular financial counsel to a client for whom he was performing a monthly audit. It might be argued, and justly so, that the accountant might give this same counsel even where a monthly audit was not being performed. Examine your experiences! Compare in your own cases the number of times you hold discussions with clients for whom you perform monthly audits, with those for whom you perform annual audits. You know very well that you practically live with the ones for whom you render frequent services and that, on the other hand, you just about re-introduce yourselves annually to your annual audit clients, unless some special circumstances have decreed otherwise.

This financial counsel may be along the lines of any business or accounting problem, but we need be concerned only with those services that are most frequent and important, and that may be generally termed as "aid to management".

All of us have heard the word budget and know its meaning. Fewer of us, however, employ budgets in the affairs of our clients. I will dwell but generally on the subject inasmuch as it will be covered in more detail in a later paper.

Those accountants who prepare budgets for their clients, do so, of course, with the assistance of the management. The budget is generally prepared on a monthly basis with due regard to seasonal variations. Its object is to mark a lane,

so to speak, over which the client may navigate a clear course with the aid of a competent pilot. The lane need be continually charted to give effect to variations and changing conditions. The accountant who performs a monthly audit is in a position to do his charting that frequently.

After the accountant has performed his routine audit steps, he will usually want to present, by means of a report, a clear picture of the financial condition and operating results to his client. The form, content and completeness of the report will vary with the particular business and the client's wishes. It may or may not embody details with respect to the comparison of the budget as laid down and the actual results achieved.

The scope and content of the report is a matter that will be dealt with by another speaker.

The monthly audit serves, too, in enabling the accountant to render prompt tax advice to his client. This often avoids overpayments and, at the same time, permits of the minimizing of the client's tax liability by the proper timely guidance throughout the year.

Several other advantages that a client may derive from a monthly audit, are:

(1) The client's financial, business and accounting problems may be reviewed currently, in the light of swiftly changing conditions.

(2) The effect of the accountant's periodic visits serves to keep the client's staff on its toes and, at the same time, allows the accountant to review regularly the competency and adequacy of the client's personnel.

(3) Along with this latter point the accountant may ascertain *currently* whether among his larger clients the various department heads render accurate reports to the management.

Now, then, from the credit grantor's viewpoint:

No one knows better than the credit grantor the value of current and accurate financial information with respect to his risks. Undoubtedly, the best source for this information is the accountant's monthly report. The report may vary in content from a mere classified trial balance, prepared after giving effect to the accountant's adjustments, to detailed financial statements accompanied by explanatory notations.

In these uncertain days the basis on which credit is initially granted, may be altered considerably in a very short space of time. The financial picture of one month may be almost unrecognizable the next. The accountant's monthly report certainly allows for a clearer perspective currently.

Not only does the report serve as a "news bulletin", but it may form the actual basis for the extension of credit. It may be said in all fairness that the rendering of monthly reports is of equal advantage to both the credit seeker and the credit grantor.

It is established procedure in certain lines of business, where conditions fluctuate frequently and violently, for the accountant's report, or certain portions of it, to be delivered over the telephone to credit grantors—this with the client's consent, of course. Such matters as bookings, current policy with respect to mark-ups, etc., are customarily dealt with. This is timely service indeed.

Can there be any doubt of the more secure feeling on the part of the credit grantor, if he is aware that a monthly examination is being conducted for one of his risks by a competent accountant, and that he will be apprised of that accountant's findings currently?

And, lastly, from the accountant's viewpoint:

It is rather unfortunate that many of our clients have not been educated as to the desirability of adopting a natural business year. The resultant effect is the mass closing of books on a December 31 fiscal year basis. This contributes greatly to the so-called seasonal period that accountants are faced with between January and March of any year. Recognizing this situation, it is apparent that the average practitioner, if his accounts were all in the annual engagement category, would be quite busy about three months of the year. Undoubtedly, special work would arise during the remaining nine months, but probably insufficient in amount to warrant the retention of a complete and permament staff throughout the entire year.

The monthly audit will usually provide the accountant with twelve audits instead of one. It enables the accountant to maintain a permanent staff, trained in the procedures of the organization, so that, not only may the monthly audits be disposed of and work spread over the entire year, but the peak season finds a fully trained staff on hand to meet the situation.

By performing the audit monthly throughout the year, the accountant's work is usually eleven-twelfths finished at the time the client's fiscal period ends. If that date is December 31, as it very frequently is, then so much less pressure is brought to bear on the accountant's organization during the peak period.

In addition to reducing the volume of work when time is at a premium, the monthly audit tends to a greater efficiency in the accountant's internal organization. As has been mentioned, he has a trained accounting staff. It also follows that he must have a trained typing and stenographic department and other internal office help. Accustomed to routine laid down throughout the year, it is hardly a transition for the office staff to get into the swing of things when pressure is greatest.

The practitioner, in his contact throughout the year with his clients, has his fingers on the pulse of general business conditions. It is especially true if a number of his clients are in the same line of business. This familiarity not only allows for the disposition of problems more currently and efficiently over the entire clientele, but has the tendency of doing away with, "leaving for tomorrow that which can be done today". The airing of problems throughout the year decidedly eases the time tension during the peak when it is required most, especially among the executive and administrative members of the staff who might otherwise be required to dispose of an accumulation at the time of the closing.

Another advantage is the closer relationship between accountant and client engendered by the constant contact. This relationship, if properly applied, serves to educate the client as to the necessity of the accountant's services. This is especially true if the client is employing accountants on a monthly basis for the first time.

However, if the adage "familiarity breeds contempt" is to be kept within the bounds of mere words, let your service be a constructive one!

However, all is not "gravy". The monthly audit consumes more time in the aggregate than an audit performed but once or twice a year. More time means greater cost—but, greater cost does not necessarily spell greater fee. So that, even though certain benefits have been derived by the accountant, there is no doubt they are somewhat offset by their costliness.

Special Features of Monthly Audits

By JOSEPH SANDLER, C. P. A.

THE preceding speaker has told you in a general way the part that a monthly audit plays in the practice of a public accountant and in the business life of the client who has availed himself of this type of service. In the time allotted to me I will discuss some special features covered by the accountant in performing his monthly audits which emphasize the value of this service to the client and illustrate the importance attached thereto by the business man who has come to appreciate the helpfulness of the accountant in shaping his financial policies and business program. Different industries, of course, present different problems, but time limitations make it necessary for me to confine my remarks to special features that are covered in monthly audits of a few selected industries and types of organization which I believe many of you serve in a professional capacity.

So far as their purpose is concerned, the special features of a monthly audit may be broadly classified into three divisions, as follows:

1. The service that enables the accountant to guide and counsel his client in the financial conduct of his business.
2. The auditing precautions that tend to minimize the possibilities of losses through the peculation or misappropriation of the funds of the client.
3. The ascertainment and intelligent presentation of data regarded as essential by both the client and credit grantors.

One of the ways in which an accountant can assist his client in the conduct of his affairs is to establish a budget to guide him in the operation of his business. The budget can be prepared for a period of a year or for a season in industries that are highly seasonal. In the preparation of these budgets due consideration must be given to the client's working capital, the size of the organization involved, the client's past experience and other factors that affect the projected business volume, the percentage of gross profit or the overhead.

In preparing an operating budget for a concern that has been in business for some time, past performances are of vital importance. With respect to new business ventures the budget should be based upon a conservative estimate of anticipated sales volume, a normal percentage of gross profit and the overhead expenses should be budgeted accordingly. At frequent intervals comparisons should be made between the budgetary figures and the actual performances and the budget should be revised whenever it is found necessary in order to meet changes in the client's business.

In addition to an operating budget it often becomes necessary to prepare a cash budget showing a client's cash requirements at certain peak periods during the year. In arriving at the cash requirements the terms of purchase and sale prevailing in the industry are important factors. This type of information in seasonal industries is of paramount importance in order to permit of proper arrangements being made for bank credits in advance of the season.

Another type of budget that can be of material assistance to clients may be termed the "purchase bud-

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get" which forecasts the monthly purchases of merchandise. This type of budget will frequently prevent overbuying by maintaining a proper ratio between purchases and sales, and permit better timing of purchases and maturities. It will also help to avoid unusual mark-downs and assist the client in maintaining proper turnover ratios. Accountants that serve retail establishments are well aware of the effect of substantial mark-downs on a store's operating results.

In the preparation of these budgets the accountant should avail himself of data published by research agencies, such as Harvard Research, Dun & Bradstreet, and other similar organizations. Valuable information may be obtained from these services and profitably employed in the accountant's budget work. The client will be deeply appreciative of such information.

Having prepared a budget for the client the accountant must take steps to insure a performance in line with predetermined statistics. It is essential in this connection for the accountant to scrutinize the cost calculation books of the client in order to determine whether a proper percentage of mark-up is being obtained on manufactured merchandise. The percentage of mark-up shown by a comparison of the cost with the scheduled sales prices should be somewhat higher than the margin used in your budget. This excess represents the reserve provided for reductions in mark-up that may result from sales made below scheduled prices.

In jobbing concerns it is not very difficult to determine the percentage of gross profit inasmuch as a simple comparison of the purchase cost and the sales prices of the more popular items will give you a fairly representative percentage of the gross profit that the client is obtaining on his sales. Moreover, it is a comparatively simple matter in a jobbing business to organize the client's records so as to permit of the costing of each sale. This will enable you to determine the total monthly gross profit earned by the client and by deducting therefrom the expenses for the month the resultant net profit or loss may be ascertained. Of course, this does not take into consideration fluctuations in the market values of the inventory remaining on hand at the end of the month.

After having scrutinized a client's cost records and satisfied yourself that a proper margin of profit has been provided for in the selling prices, a distinct shock is sometimes experienced when the profit and loss statement has been prepared and delivered to the client and it is found that the percentage of gross profit actually obtained is considerably smaller than that which was anticipated. The client will very often fail to see the reasons for such discrepancies and perhaps show some apprehension as to the correctness of your figures or the accuracy of the inventory that has been submitted. Much of this apprehension or lack of understanding may be avoided if provision is made for an analysis of sales consummated at less than regular prices and the amount of gross profit lost through such reductions duly stressed. This analysis may be made by someone in the client's employ as part of his regular duties and will very often avoid protracted and costly investigations in order to determine the reasons for the unsatisfactory results shown in a client's report.

The costing of sales may be used in small retail establishments but in larger retail firms the retail method of inventory control should be employed. This enables the accountant to study the initial mark-up, the percentages of mark-downs and the rate of maintained gross profit. By providing these breakdowns by departments you can, by using the previous year's figures as a base, provide the client with monthly budgets showing

the amount of merchandise he is open to buy and the amount of inventory he is expected to have on hand at the end of the month in each department. This monthly budget is predicated upon a contemplated sales volume and the budget can be regulated if there should be a substantial variation between the actual sales and the budgeted sales volume. The retail inventory control enables you to have frequent inventories taken at retail prices for comparison with the book inventories.

As previously mentioned, valuable information may be obtained from various publications concerning proper overhead ratios and your own actual experience in certain industries will give you a clear conception of normal overhead percentages. Certainly the preparation of budgets will serve as a guide to your client and enable you to detect unusually high overhead expenses and to suggest steps that you may deem advisable to correct such conditions.

With respect to the second class of special features, i.e., those which tend to minimize the possibility of loss through misappropriations, I doubt that there is anyone in this room who has not at some time or other had the experience of uncovering a defalcation, and that in a great many instances the defalcations extended over a long period of time before they were discovered despite the fact that frequent audits had been made. If we were to make monthly audits in such detail as to guarantee the discovery during the month in which the manipulations began of any misappropriation of cash or merchandise, the cost of such audits would be prohibitive. However, as the result of the experience of the members of the committee, we are suggesting that certain features be incorporated in your monthly audits which we feel will reduce to a minimum the possibilities of loss through such channels.

In addition to the regular audit of the cash account it is advisable at various intervals during the year to obtain duplicate deposit slips directly from the bank and to compare them with the cash books. In this manner any kiting indulged in by a bookkeeper or cashier may be brought to light. I recall an instance in which a bookkeeper was using customers' checks to cover up C.O.D. receipts which she had misappropriated, holding up the credit to the customers' accounts until a later date when checks received from other customers were used. An examination of duplicate deposit slips received from the bank revealed the fact that the amounts on the deposit slips did not coincide with the entries in the cash book even though the total deposits agreed. An investigation disclosed that the bookkeeper had continued to use some of the checks received daily in order to cover up previous peculations. In auditing cancelled vouchers special attention should be paid to endorsements and to checks outstanding for a long period of time.

It is important to scrutinize the accounts receivable at various intervals and to call the client's attention to apparently slow-paying accounts. This will sometimes disclose that a customer has paid but that the bookkeeper or cashier has diverted the money to his own use. Where your audit procedure does not provide for a detailed check of the accounts receivable monthly, it is advisable to check two or three different letters of the ledgers each month so that every account will have been scrutinized at some time or other during the course of a year. Special attention should be given to accounts that do not pay specific bills but pay on account.

Despite the fact that a balance sheet audit is made only once a year in most cases, the petty cash should be counted several times during the year if the fund maintained is of a

fairly substantial size. The petty cash vouchers should be written in ink and the amount written out in order to preclude the possibility of changes being made therein. A petty cash voucher that has been audited should be stamped or cancelled by the auditor.

Cash sales and C.O.D. shipments provide temptations to cashiers and bookkeepers to indulge in manipulations of the cash funds. The auditor should check such transactions to see if the cash received from these sales was deposited without undue delay.

In most industries cash or trade discounts are allowed to customers at uniform rates. If the sales are entered gross and the discount deduction is shown in the cash book, the accountant should determine whether any customer has been credited for discounts allowed at a higher rate than the customary percentage. I have in mind a situation wherein a customer paid an invoice of $2,100.00 by check in the amount of $1,932.00, having deducted $168.00 representing 8% discount to which he was entitled. The bookkeeper credited the customer with $2,100.00 but entered only $1,872.00 in the cash column and $228.00 in the discount column. On the next line the sum of $60.00 was entered and credited to the cash sale account and the $60.00 actually received for a cash sale was misappropriated. An examination of the discount column by the auditor disclosed the excess credit for discount and the fraud was discovered. A further investigation revealed the fact that such peculations had been carried on over a period of several months and involved quite a substantial sum.

The auditor should always obtain the client's approval on "void" charges and sales allowances. Sales returns should be checked against receiving records. The reasons therefor are quite apparent.

Misappropriations of merchandise may be minimized through the installation of perpetual inventory records. If the expense of maintaining perpetual inventory records is too great, you may provide for a weekly unit count whch should be reconciled with units purchased or manufactured.

The practice of making a unit count has been adopted quite generally in the dress and coat industry, and I believe this has to a great extent reduced the amount of pilferage. Some executives in the cloak and suit industry have gone so far as to provide for a daily count.

It may be said that it is preferable to have a partial perpetual inventory record to no record at all. In these cases an inventory record is kept of the more expensive items.

A comparison of the gross profit percentage reflected by a statement of income and profit and loss with the margin of gross profit shown by the cost calculation books may indicate discrepancies which upon investigation may prove to be the result of continual pilferage by employees.

With the advent of the social security taxes the payroll records of business concerns have been materially improved and the possibility of fraud reduced. It is still advisable, however, for the auditor to test-check payroll cards against the payroll book and at infrequent intervals to make the actual distribution of the payroll envelopes.

In order to assure the auditor that no invoices will be paid unless the merchandise represented thereby has been received, it is advisable in some cases to check the purchase invoices against the receiving records. Where the time allotted to the audit does not permit of the inclusion of this operation frequent test-checks should be made.

We now come to the third and last part of my discussion of special features of monthly audits, viz., those which tend to insure the presentation

of correct figures to the client and the credit grantors. I am not referring to the report issued as the result of a balance sheet audit.

Most of us can remember the time when a financial statement would be issued on behalf of a client at the end of a fiscal or calendar year and no further information was available to the credit grantor until the close of the following year. However, during recent years the accountant has been burdened with the task of submitting to banks and credit men periodic information which has a vital bearing upon the amount of credit obtainable by the client. Of course, this information is only given with the approval of the client. In this connection it should be borne in mind that the monthly reports prepared by the accountant are frequently used by the client to give his creditor up-to-the-minute information. We are, therefore, not surprised to find that attempts are frequently made by clients to cause their books to reflect a more favorable condition than that which actually exists. We must be continually on our guard to see that the information given orally or through the medium of our monthly report is accurate.

The methods commonly resorted to in order to reflect an inflated financial condition and the steps that should be taken to guard against the falsification of records may be summarized as follows:

Inflating Accounts Receivable — It is essential that the auditor scrutinize the sales book and take special note of invoices of unusually large amounts. These invoices should be checked against express receipts and the original orders received from the customers. If the auditor is not fully satisfied as to the authenticity of these sales invoices, direct communication with client's approval should be had with the customers involved for the purpose of obtaining confirmation of the correctness of their accounts. This is essential even during monthly audits where suspicion exists.

Instances have been discovered of collusion between a client and his customer in which the customer confirmed the correctness of the balance due from him but further investigation proved the account to be fictitious. Accounts receivable are very often inflated by the shipment of merchandise on open order or on consignment. An examination of the sales returns of the succeeding month will usually disclose such inflation.

Express receipts should be examined to make sure that shipments made during the first few days of a month have not been added to the sales of the preceding month. In one instance a client was found to make it a practice to keep his sales book open until the 10th of the succeeding month, and to close his purchase book on the 20th day of the month under review, with the result that his books reflected a ratio of current assets to current liabilities which was considerably distorted.

Unusual Cash Deposits — Large cash deposits are sometimes made just before the end of a month in order to cover officers' overdrafts or to reduce partners' drawing accounts and thereby improve a company's cash position. The auditor must ascertain whether or not the cash has been withdrawn immediately after the close of the month. The check stubs for the succeeding period should be examined to determine whether such large withdrawals were made. The money may in fact have been withdrawn through the medium of checks taken from the back of the check book and no check stubs made out in order to conceal such withdrawal. It is, therefore, advisable in cases where large deposits have been made on the last few days of a month to call for the bank statement during the middle of the following month and to reconcile the

balance appearing thereon with that shown by the books on that date.

Inventories — Where inventories are submitted periodically by a client for use in the preparation of the auditor's reports, the auditor should attempt to determine the accuracy thereof by test-checking the record of the stock on hand against recent purchases or production records. The raw material prices should be checked against purchase invoices and the prices shown for finished goods should be compared with subsequent sales invoices. Of course, finished goods in the inventory should be evaluated at an amount that indicates a normal percentage of gross profit when compared with the most recent sales invoices.

Retail inventories are very often inflated through the failure on the part of a client to make a proper record of his mark-downs or because of his neglect to take mark-downs during the proper period. It is, therefore, important for the auditor to examine the original mark-down record for the current month and for the next succeeding month. Abnormal mark-downs taken immediately after the close of a month are usually an indication that a considerable part of such mark-downs should have been taken prior to the close of the month.

Special attention should be directed to loan and exchange accounts. A close scrutiny of the entries in these accounts may disclose borrowings from finance companies and the hypothecation of accounts receivable or other assets to secure unpaid loans.

Understatement of Liabilities — There have been cases where clients have held back purchase invoices from the bookkeeping department for the purpose of preventing the accountant from reflecting all the liabilities of the client in his monthly report. It is, therefore, incumbent upon the accountant, in making a monthly audit, to attempt to ascertain whether or not all liabilities have been recorded. An examination of the receiving records should be made to see that all invoices for merchandise received during the month have been entered in the purchase book. An examination of the invoices entered in the purchase book in subsequent months may reveal the fact that some of the invoices bear earlier dates.

Those of you who serve clients in the business of manufacturing ladies ready-to-wear know that a substantial number of these so-called manufacturers have their merchandise manufactured by contractors. In most cases the contractors are charged for the raw material sent to them and credited for the finished merchandise delivered by them. The difference between the two amounts represents the agreed labor price. I have seen monthly statements which set forth as an asset or a liability the debit or credit balance, as the case may be, shown by the contractor's controlling account. This is obviously incorrect. The auditor should analyze each contractor's account, setting up the amount of merchandise in the possession of the contractor as a part of the client's inventory and the amount due for labor as a liability to the contractor.

It is sometimes possible to discover unentered liabilities through an examination of the cash book for the subsequent month. Accrued expenses, commissions or special bonuses are usually ascertainable through subsequent cash book entries.

The auditor must be careful to give effect to liabilities for social security taxes or other tax assessments that remain unpaid. Contingent liabilities because of proposed additional assessments of income taxes and possible liabilities for windfall taxes must be noted in the auditor's report.

In connection with monthly audits of companies in seasonal industries

it is advisable to prepare at certain times during the year schedules of purchase commitments and customers' orders on hand and to incorporate such data in the report. Balance sheets and operating statements prepared at the conclusion of monthly audits may sometimes indicate an unfavorable trend unless consideration is given to orders on hand for merchandise to be shipped shortly after the date of the balance sheet. In many instances merchandise may be finished, packed and ready for shipment and such information should be made available to those whose business dealings with the client make it necessary for them to keep currently informed with respect to his financial status.

A careful study should be made of the adequacy of the insurance coverage. A client whose inventories fluctuate widely because of the nature of his business may sustain substantial losses due to insufficient coverage if a fire should break out when his inventory is at its peak. It is, therefore, advisable to examine the insurance policies during the year for the purpose of determining whether any specific recommendations should be made to the client in order to make sure that he is fully protected against such possible happenings. Use and occupancy insurance should be recommended in situations where a compulsory stoppage will result in large losses because of high fixed charges or other factors.

During the course of his audit, commensurate with the time available, the auditor should study the functions and activities of the various departments of the business and make recommendations to increase their efficiency. He should add to the scope of each monthly audit a special investigation of one or more phases of the client's business, such as the operation of the receiving, shipping, production, and buying and selling departments, and the functioning of the system of inventory control.

Many of the points stressed in this discussion are applicable to balance sheet audits as well as monthly audits. However, because they are frequently lost sight of in the performance of a monthly audit they are brought to your attention.

In conclusion, it is my opinion that the accountant who includes special features of a constructive nature in his monthly audit program will find that his work will become increasingly valuable to the client who will look forward to receiving his reports, and the progress of the accountant will thereby become enhanced with a resultant increase in his income.

Monthly Audit Administration, Working Papers and Reports

By Sidney B. Kahn, C. P. A.

ALTHOUGH there are extensive and elaborate books and treatises dealing with administration, working papers and reports, in general, little attention has been given to the special problems under these headings arising in connection with monthly audits. In this paper the various points under discussion will be treated strictly from the point of view of the monthly audit.

Under each topic, certain prevalent practices are enumerated and some specific procedures are recommended. It is, of course, understood that the procedures outlined are suggestive and cannot be applied under all circumstances.

I. ADMINISTRATION

A. Audit Programs:

It is not intended to discuss in detail the various audit steps entailed in making a monthly examination. Instead, reference is made only to the use of audit programs.

Written programs, of one kind or another, are almost indispensable in the conduct of monthly audits. There are two general types in use. They are:

1. Standardized forms listing all steps to be covered on every audit. One program is used for each engagement. The various steps to be performed are indicated thereon.
2. Individually written programs designed especially for each engagement.

Both types of programs generally have the following in common:

1. The individual operations to be performed are listed on the left hand side in summary fashion;
2. Columns are arranged on the right hand side for the months of the year;
3. The frequency with which the various points are to be covered and whether each is to be made the subject of test or done in detail is indicated on the program (usually by a key such as this: — M for mandatory, D for discretionary, T for test, B for bimonthly, Q for quarterly, etc.).

It is extremely desirable to use the aforementioned audit programs in conjunction with standard manuals of audit procedure. Such manuals should emphasize throughout that the auditor must always be on the alert, and that the detailed written program cannot act as a substitute for the exercise of intelligence, vigilance, and good judgment.

B. Staff:

The many points relating to staff training, education, rules of conduct, etc. applicable to auditing generally apply, of course, to monthly audits with equal force. It is not necessary to dwell upon these subjects here. It may, however, be well to touch upon the matters of rotating the staff and contacting the client.

There appears to be little uniformity with respect to assigning engagements to the staff. Many practitioners do not alternate their staff men from

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month to month on the same engagement. Against rotating, there is this to be said—the client prefers that the same auditor make the examination every month believing him to be more efficient because of his greater familiarity with the audit; and, the accountant will generally find the task of assigning work much less difficult where his men are not transferred from one engagement to another. On the other hand one must give heed to other considerations:

1. Uninterrupted performance by the same auditor may tend to make his work perfunctory;
2. Undue familiarity between the assistant and the client or his employees may result from too frequent visits;
3. Rotating men often affords the principal an opportunity to measure the comparative efficiency of the several staff men;
4. Different men may bring different and fresh points of view to the engagement; and
5. It is desirable to have more than one staff member available who is intimately familiar with each audit.

C. Client Relationship:

As to the proper relationship with the client, it is a good policy for the principal to maintain as close professional contact with him as time will permit. Personal calls at occasional intervals are most desirable. Unfortunately the client frequently does not understand that his affairs are receiving the attention of the principal. Some clients feel that the principal manifests a lack of interest in their problems when his calls are too sparsely spaced.

D. Work Control and Supervision in the Accountant's Office:

There are many variations in procedure with respect to the details performed in the accountant's office in connection with the supervision and control of monthly audit work.

I shall present a chronological outline of a simple plan which, with some variations, may be adapted to different working conditions.

Engagement Register

The first basic record is the Engagement Register. This is a continuous journal in which all engagements are listed giving the number, name of client, nature of work, date or period covered, and, for new engagements, the date commenced. The engagements are numbered chronologically, a new number being assigned for each fiscal year. It has been found helpful to distinguish recurring audits from special work by prefixing the engagement number with an "R" or an "S". Monthly work can be differentiated from year-end work by appending the letters "a" or "b" to the engagement number. All files, bills, time records, tax returns (and sometimes correspondence) should bear the number assigned to the engagement.

The next subject to be considered is that of assigning and following-up monthly audit work.

Monthly Work Schedule

In the case of offices having a comparatively small practise, a Monthly Work Schedule (as illustrated in Figure I) will provide a tractable starting record. This schedule is prepared at the beginning of the month and lists all monthly examinations to be performed during the month, in the order in which they are generally ready. It is arranged in columnar form to provide the following information:

1. Engagement number
2. Name
3. Ready date
4. Budget time
5. Auditor
6. Started—Date, hour
7. Completed—Date, hour
8. Time taken

WORK SCHEDULE

MONTH ENDED

ENGAG. NO	NAME	READY DATE	BUDGET TIME	AUDITOR	STARTED		COMPLETED		TIME TAKEN	
					DATE	HOUR	DATE	HOUR	DAYS	HOURS

FIGURE I

The schedule of the month before and the schedule for the corresponding month last year (for bi-monthly, quarterly, and other than monthly interim audits) will provide a helpful guide in preparing the program for the current month. When the month's work is completed, the schedule is preserved for later use.

Engagement Record Card

For larger organizations a monthly follow-up record such as the one just described may be inadequate or otherwise impractical. Instead a flexible card system may be employed whereby the same record can be used repeatedly for a year or more. Under such a plan a card is prepared for each monthly engagement covering the fiscal year. The cards are kept in a separate file which is divided into three sections:—(1) To be done; (2) In process; and (3) Completed. As engagements progress from one stage to another, the respective cards are transferred to the appropriate section. The card itself (Figure II) is designed to provide substantially the same information as given in the Monthly Work Schedule previously discussed. Where a simple cost system is in operation, the card, after making some modifications, may be made to serve the dual purpose of cost card and follow-up record.

Weekly Assignment Sheet

The foregoing records will not in themselves provide adequate means of controlling the assignment and performance of engagements. A weekly assignment or location sheet is almost indispensable. Such a sheet should be prepared in advance showing the tentative work assignments for each member of the staff for the ensuing week. As the week progresses all necessary changes from the original assignments are noted directly on the sheet. This form (see Figure III) consists of a number of vertical columns the first of which is used for the days of the week (given by name and date). The remaining columns are headed by the names of

ENGAGEMENT RECORD CARD

NAME									ENGAG. NO.		
NATURE OF WORK											
YEAR ENDED					BUDGET TIME						
READY DATE		STARTED		AUDITOR	MONTH	FINISHED		TIME TAKEN			
		DATE	HOUR			DATE	HOUR	DAYS	HOURS		
1										1	
2										2	
3										3	
4										4	
5										5	
6										6	
7										7	
8										8	
9										9	
10										10	
11										11	
12										12	

FIGURE II

WEEKY LOCATION SHEET

WEEK BEGINNING Jan 3, 1938

AUDITOR	MONDAY 3rd	TUESDAY 4th	WEDNESDAY 5th	THURSDAY 6th	FRIDAY 7th	SATURDAY 8th
Alberts						
Brown						
Connor						
Duffy						
Edwards						

FIGURE III

the members of the staff. Where the staff names are too numerous to be accommodated in this fashion, the alternative of arranging the names vertically and the days horizontally, readily suggests itself.

Ready Dates

An unsystematic method of arranging for audit dates would of course seriously impair the efficiency of work control. The matter of ready dates thereby assumes much importance. Ready dates may be obtained by telephone calls or by written notifications from the client. For the latter purpose a printed postcard form may be distributed by the accountant to his clients. A follow-up system should be maintained in the accountant's office whereby clients are communicated with if not heard from within a reasonable time. A complete, up-to-date list of ready dates should be available at all times.

Time and Cost Records

There is little to be said about time and cost records that is peculiarly applicable to monthly audits. It may not be amiss, however, to emphasize the importance of strict adherence to the cardinal requirement that staff time reports be rendered to the office promptly. In view of the shorter intervals between examinations, this is of great moment in organizations where monthly audits prevail.

All time records might well be made to distinguish between time spent on regular monthly work on the one hand, and on tax and year-end work on the other. Time spent on special work for the same client, outside the scope of the regular engagement, should be separately recorded.

Billing

As fees for monthly audits are generally on an annual retainer basis payable monthly, billing should preferably be done monthly upon completion of the audit (including the report). Where year-end work, as opposed to monthly work, involves, relatively, a considerable expenditure of time, it might be preferable to arrange for a separation of the annual retainer as between a monthly and year-end fee. This would, of course, require separate billing.

Filing

The subject of filing generally has no place here. Suffice it to say that it is advisable to separate monthly from year-end and any other working papers of the same client, and to file copies of typewritten monthly reports together with the working papers.

II. WORKING PAPERS

The subject of working papers is one upon which several very good text books have been written. It is not intended to repeat or dwell upon any of the interesting topics found in these texts. The discussion will be limited to conditions encountered only in monthly audits.

There appears to be a substantial lack of uniformity of practice with respect to mechanical features, technique, content, and other phases of working papers prepared in connection with monthly audits. This makes it extremely difficult to report what is generally done in this regard. With your permission, I shall attempt to describe a system of monthly working papers with which I am familiar.

Mechanical Features

This system is based upon the use of 8½" x 11" analysis paper. This size (which provides only 2 or 3 less horizontal lines than the larger sheets), has been found to have many advantages over the more commonly used 8½" x 14" paper. All other stationery conforms to the size of the analysis paper. The following comprises the stationery required:

1. File envelopes, expanding type with open top. For current

papers this seems preferable to the usual closed top documentary envelope;

2. Closed top expanding file envelopes for closed files;
3. Two-piece file covers of heavy stock oak tag;
4. Index sheets with alternating tab extensions;
5. Paper, consisting of:
   - (a) 8½" x 11" analysis paper with from 4 to 7 money columns, as preferred;
   - (b) 17" x 11" analysis paper with 12 or 14 money columns;
   - (c) 25½" x 11" analysis paper with 21 money columns;
   - (d) 8½" x 11" note paper with horizontal rulings only, used for text matter and memoranda.

The paper, index sheets and covers are all uniformly punched on the left hand side for binding.

Arrangement of Current File

A complete set of current monthly audit working papers is arranged as follows:

1. The open top file envelope is the container in which the papers are kept. The name and engagement number is typewritten or printed on the outside upper left hand corner of the envelope.
2. The envelope contains two separate sets of papers each bound in the heavy tag covers referred to above. One set constitutes the monthly working papers file and the other is the permanent file.
3. The permanent file, which contains the usual papers relating to organization, capitalization, leases and other such matters, is separately bound and contains an index of its contents. These papers should be readily accessible to the auditor when he is engaged in making his monthly audit. Too frequently these papers are buried somewhere in the office with the year-end or other files.

The current monthly working papers file is separately bound and contains:

1. Working papers for each month grouped in this order:

(a) Typewritten copy of report

(b) Longhand draft of report

(c) Special matters for attention of office

(d) Trial balance and/or work sheet

(e) Adjusting journal entries (to be made in the books)

(f) Reconciliation of cash

(g) Other analyses and schedules arranged in order of their position on the trial balance

(h) Memoranda of matters arising and disposed of during the audit, and

(i) Last month's memoranda for disposition this month.

Index sheets with tab extensions bearing the names of the months are used to separate the papers of one month from another. The earliest papers are kept at the bottom of the file.

2. Working papers required for all monthly audits of the current fiscal year are grouped together and kept at the top of the file. These papers generally consist of:

(a) The audit program

(b) A schedule of pro rata monthly charges for insurance, depreciation, taxes, interest, bad debts, and the like, together with detailed

computations supporting them

(c) Monthly journal entries for report purposes, and

(d) Skeleton report forms typewritten in advance for auditor's draft of report.

At the end of the fiscal period, after the year-end examination is completed, the monthly working papers are transferred from the current file envelope to a closed-top file envelope in which the year-end examination papers are also placed. After proper labeling the closed file is then filed away according to engagement number.

The new current monthly file is then opened. The next succeeding available engagement number is assigned to it. The permanent file is brought forward and again kept with the current papers.

Classification of Accounts

Where monthly audits are made, it is especially advantageous to work with books of account that are appropriately designed. This will aid the auditor in performing his work with the greatest efficiency and minimum waste of effort. A well classified general ledger, arranged with a view to curtailing analysis work and affording a ready basis for the preparation of reports, is the end to be sought. The accountant should carefully consider the advisability of reclassifying the accounts even though this may have to be done at his own expense. This will often prove to be an investment that pays handsome dividends.

In classifying the general ledger, columnar accounts can be employed to advantage. Frequently the general ledger designed for monthly audit purposes will be somewhat different from an otherwise satisfactory arrangement. For example, a general ledger columnar account entitled "Charges for Later Allocation" can be beneficially employed as the repository for such items as taxes, interest, water charges, insurance, license fees and other fixed charges. The use of this account will be referred to again later.

Trial Balance and Adjustments

The manner of preparing the work sheet and the detail required in connection with it will, of course, be governed to a great extent by the report that is to be rendered. Monthly adjustments may be made in one of three ways:

1. Directly on the books
2. In the working papers and posted directly to the report, and
3. In the working papers and posted to the work sheet.

Under the first two methods the same sheet may be used for six or more monthly trial balances without rewriting the names of the accounts, two money columns being used for each month.

A similar method may be followed to record journal entries in the working papers. Another economy of effort in connection with journal entries made for report purposes is accomplished by combining in one entry the reversal of accruals for the prior month and the recording of the same for the current month. This is done by entering both a debit and credit for the same account on the same line. Prepayments and inventories may also be journalized in this way.

Time Savers

The office can save the staff considerable time with respect to some written details that are required month after month. The typing department can prepare manifold copies of the text material in the various exhibits and schedules constituting the report as well as comparative figures of prior periods. The auditor is thus supplied with a skeleton re-

port to which he need only add current figures and make whatever changes in terminology are necessary.

Wherever possible, the auditor should accumulate data from month to month that may be necessary or helpful in connection with the year-end work. Obviously, this has the advantage of lightening the burden that falls upon us at the busiest time of the year.

III. REPORTS

The word "report", in a broad sense, may be defined as an official statement, a published account. As treated herein, a monthly audit report will be considered to be any regular, written, interim account or statement submitted by a public accountant to or on behalf of his client, regardless of its form or content.

Comment will be limited to points that are peculiar to, or of special interest or importance in connection with monthly audits.

In actual practice, accountants' monthly reports vary widely. Reference will be made to certain features in such reports. The more common types of monthly reports are:

1. Those comprised of two main exhibits—a balance sheet and an income statement, based upon physical, perpetual, or estimated inventories;
2. Reports prepared without inventories. These generally consist of a statement of assets and liabilities and a statement of operations, both showing the amount of inventory required to keep capital intact; and
3. Classified general ledger trial balances (in one exhibit).

A. Comments and Qualifications:

It is desirable that every monthly report be accompanied by a clear statement setting forth any and all qualifications with respect to the exhibits submitted. It is generally immaterial whether such explanations are embodied in a letter of transmittal (attached to the exhibits) or are stated on the exhibits themselves. When a letter is used the usual phrase "subject to the accompanying qualifications" should appear prominently on the exhibits and schedules.

Many accountants fail to observe this practice explaining that such qualifications are unnecessary because the monthly report is intended for the client and that he understands its limitations and conditions. This reasoning is invalid because professional accountants' reports are formal documents that should disclose the nature and basis of the figures submitted. This should be as true of monthly and other interim reports as it is of annual balance sheet audit reports. It is obvious that the accountant cannot control the use to which his report will be put after it has left his hands. Certainly where monthly reports are submitted to credit grantors, they should clearly recite what has and has not been done.

The following are some of the matters that should be commented upon:

1. Outside verifications are very rarely made in connection with monthly audits. Nevertheless the omission of such verifications should be referred to.
2. Where inventories are used, a clear statement should be made explaining how they were determined and to what extent they were verified.
3. Any undue limitations as to the scope of the audit imposed upon the accountant by his client should be fully but tactfully set forth.
4. The failure to make adjustments for accruals, prepay-

ments, bad debts, depreciation and the like, is to be discouraged, and should, of course be brought to light. Where the cumulative operations from the beginning of the year to date have resulted in a profit, both the balance sheet and income statement should bear a footnote with respect to the treatment given income and profits taxes.

5. When reporting upon highly seasonal enterprises or upon others where it is pertinent, purchase and/or sales commitments might well be shown in the monthly report. This information is extremely valuable to the client and his credit grantor.

   Where it is not practical to do this in the monthly report, attention should be directed to the omission.

6. The preceding statement applies with equal force to all other contingent liabilities.

7. The monthly report furnishes a vehicle to the accountant with which to convey to his client matters of special interest and importance. Some of these matters are:

   (a) Important changes in financial condition

   (b) Variations in operations

   (c) Recommendations

   (d) Unusual points disclosed by the audit, and

   (e) Matters about which the accountant wishes to go down on record with the client.

It is sometimes desirable to make some of these items the subject of a separate letter to the client.

B. Balance Sheet:

For some unexplainable reason balance sheet comparisons are very seldom found in monthly audit reports. Comparisons of the present position with the financial condition at the close of the previous month, the beginning of the fiscal year and the corresponding date a year ago, will often prove enlightening.

C. Income Statement:

Comparisons

Certainly income statement comparisons should be given wherever feasible. Comparisons with the previous month or with the corresponding month a year ago are generally valuable.

Current Month and Year to Date

The profit and loss statement is often of limited value unless it reflects the operations for both the month under audit and the year to date. Such a statement should be supplemented by a summary of the final net results for each month for the year to date.

Percentages

Percentages judiciously used are the basis for analysis and interpretation of the income account. Variations in operations cannot be intelligently accounted for without the use of percentages or unit analysis.

Units

Wherever data are available as to units, all, or the more important items in the income statement, should be shown with averages per unit sold. These unit averages generally make for a more accurate analysis than do percentages. Some examples of units that may be used are—tons, pounds, gallons, barrels, dozens, and yards.

Budget

If a budget has been prepared or is in operation, the accountant might

well report on the monthly operations by making comparisons of actual results with the budget and showing variations therefrom.

Industry Operating Data

Where such information is obtainable averages for the industry often provide a valuable basis for comparison. Such comparisons are most interesting and enlightening to the client.

Extraordinary Charges

In view of the short period covered by the monthly income statement, unusual expenses or losses of substantial amounts, if merged with operating expenses, might obscure the picture. Where only the current month's operations are being reported upon, such expenditures should be separately shown, preferably below operating income. This notwithstanding that some of these items are properly treated as operating expenses in the yearly statement. A similar procedure should be followed with respect to relatively large expenses applicable to prior months but recorded in subsequent months.

If the income statement gives monthly and year-to-date figures, it may be impracticable to follow the procedure just suggested. In such cases unusual items and expenses of prior months should be brought to light by parenthetically adjoining explanations, by footnotes on the statement, or, in some cases, by comments in the text of the report.

Inventories

The matter of inventories in monthly audit reports is one that has, no doubt, engaged the careful consideration of many practitioners. We all know that for many of our clients it is impractical and sometimes well nigh impossible to take monthly physical inventories. The problem has been met in practice by preparing monthly audit reports based upon:—perpetual inventories, retail method inventories, detail costing of individual sales, percentage of gross profit inventories, fixed and constant inventories, and inventories estimated by the client.

The mentioning of these inventory methods should not be construed as an unqualified recommendation for their use under any and all conditions. On the contrary, the accountant must carefully consider each case to determine whether the method adopted is the best available under the circumstances, and whether it will consistently produce substantially accurate results.

As it is the accountant's function to make his monthly reports as enlightening as possible, he will serve all concerned best by rendering them with inventories wherever feasible. As stated hereinbefore, such reports should fully and clearly explain how the inventories were determined and to what extent they were verified.

If no inventories are used, the report will generally be more intelligible if prepared to show the so-called "break even" inventory. Thus, the assets and liabilities are shown in one exhibit and the operating accounts in another, both arranged according to the regular classifications used. The "inventory required to keep capital intact" is given as the balancing figure in both exhibits.

Where physical inventories are used, the auditor should exercise great care to ascertain that the proper cut-off has been made in the matter of receiving and shipping. This assumes considerable importance in connection with monthly reports as any error in inventories would naturally have an exaggerated effect in view of the short operating period.

Mark-downs or reductions in inventory values, if ascertainable, should be reflected currently in monthly reports. They should not be permitted to accumulate until the end of the season or year.

Charges for Later Allocation

Reference has been made to a general ledger account entitled "Charges for Later Allocation" used as a repository for such items as taxes, interest, water, license fees, insurance, and the like. The purpose of this account is to segregate those charges which find their way into the books of account at irregular intervals or at intervals exceeding a month. Columns provide for the necessary classification.

In preparing the monthly report predetermined monthly pro rata charges for the items referred to are taken up in the income statement and the "Charges for Later Allocation" account is appropriately merged with the accruals and prepaid items on the balance sheet.

Predetermined Monthly Charges

Manifestly, accurate monthly balance sheets and income statements must reflect, respectively, all known and ascertainable assets and liabilities, and income and expenses. This presupposes the predetermination and proration of various items of cost and expense.

Extreme care must be exercised both in estimating the aggregate charge to be absorbed and in determining the method of spreading it. Some charges are best allocated in equal monthly amounts whereas others are more properly distributed on the basis of sales or production.

It should be remembered that, in the last analysis, the end to be accomplished is that the aggregate of the operating results of the twelve months must closely approximate the net profit or loss shown on the yearly statement.

Obviously, monthly income statements should reflect currently all ascertainable costs, expenses and losses, of whatever nature. This will avoid substantial season or year-end adjustments for bad debts, inventory mark-downs, and other such items.

General

May I express the opinion that in preparing monthly audit reports the accountant should depart from "so called" orthodox presentation when, by so doing, he can tell his story more clearly and less technically. Stereotyped forms, set-ups, and terminology should be avoided where more lucid and more accurate expression can be substituted.

Authors of Articles In This Issue

CHESTER T. LANE
Assistant General Counsel of the Securities and Exchange Commission.

VICTOR H. STEMPF, *C.P.A.*
First Vice President of the Society.

LAWRENCE J. SEIDMAN, *C.P.A.*
Member of Society.

JOSEPH SANDLER, *C.P.A.*
Member of Society.

SIDNEY B. KAHN, *C.P.A.*
Member of Society.

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